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LEATHER INDUSTRIES OF KENYA

Direct Loan Case Study

PRE Project Number 940-0002.12

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LEATHER INDUSTRIES OF KENYA

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Leather Industries of Kenya (LIK)

I. Economic Environment

The Kenyan economy is based on agriculture, and the livestock industry represents approximately 9 percent of Gross Domestic Product and 26 percent of national agricultural income. While Kenya has been a net exporter of meat products (Table 1), the amount of that export sector has been erratic due in part to the recent drought, market forces, and increased population growth leading to growth in domestic demand. The country has traditionally fulfilled its domestic requirements in meat. However, local consumption (through processing) of hide and skin byproducts has represented only 10 percent of the total amount of hides and skins available. Such manufacturing does not demonstrate any consistency in terms of growth (Table 2).

Exported hides and skins have, for the most part, been in the form of raw hides, i.e. dried and salted for use by leather processing industries elsewhere. For example, between 1979-1980, exports of raw hides represented 75 percent of the total weight of hides exported. Semi-processed and finished leather constituted 20 percent and 5 percent respectively. The Kenyan government imposed a total ban on raw hide export in June 1980, but was persuaded to withdraw the ban and has substituted a descending scale of export levies on hide and skin byproducts keyed to the amount of processing accomplished in Kenya. This has stimulated the tanning industry to some extent, however, at the time of this loan Kenya was one of the few countries that still marketed the majority of its production in the form of raw hides (Table 3). Normal production of hides in Kenya ranges between 1.8 and 2 million hides per annum, rising during periods of drought when livestock assets

Table 1
Kenya Meat and Meat Products Exports

<u>Year</u>	<u>Quantity</u> (Tons)	<u>Value</u> (000 Kshs)
1982	2,916	
1983	2,367	
1984	4,294	148,178
1985	3,669	137,718

Table 2
Quantity Index of Kenya Leather and Footwear Manufacturing Output
(1976 = 100)

<u>1981</u>	<u>1982</u>	<u>Percent</u> <u>Change</u>	<u>Percent</u> <u>1983</u>	<u>Percent</u> <u>Change</u>	<u>Percent</u> <u>1984</u>	<u>Percent</u> <u>Change</u>	<u>Percent</u> <u>1985</u>	<u>Percent</u> <u>Change</u>
111.0	92.8	-16.4	93.1	+3.2	81.3	-12.7	80.1	-1.5

Table 3
Exports of Kenyan Raw Hides and Leather
(U.S. \$000)

	<u>1978</u>		<u>1979</u>		<u>1980</u>		<u>1981</u>		<u>1982 (Est)</u>	
	(000)	%	(000)	%	(000)	%	(000)	%	(000)	%
Raw Hides	1,130	70	1,510	70	870	59	1,380	68	1,200	56
Semi-Finished	470	29	500	23	540	37	590	29	840	40
Finished	<u>10</u>	<u>1</u>	<u>160</u>	<u>7</u>	<u>60</u>	<u>4</u>	<u>60</u>	<u>3</u>	<u>90</u>	<u>4</u>
	\$1,610	100	\$2,170	100	\$1,470	100	\$2,030	100	\$2,130	100

are frequently among the first to be liquidated. Leather processing capacity in Kenya has increased around 30 percent over the last five years and is presently in the neighborhood of 1.1 million hides per year, leaving approximately 45 percent to be exported in raw form. The project at full production will process approximately 13 percent of the unexploited portion of hides produced in the country.

II. LIK and The Banking/Finance Sector

Although Leather Industries of Kenya's "parent company", Investment Promotion Services (IPS), carries high status in Kenyan banking and financial circles, it was faced with a continuing unavailability of long term credit of the necessary magnitude within local financial markets. While LIK could possibly have taken advantage of "longer than long term" overdraft and local line of credit facilities available to IPS, the total requirement for capitalization of the enterprise greatly surpassed local norms for overdraft and lines of credit facilities. In addition, "no equity investor would accept a project that involved such a large amount of short term callable credit", according to Mr. Poonawala, the Projects Director of IPS. Capital equipment needs for the venture also involved foreign exchange purchases, for which long term credit was virtually impossible to obtain in Kenyan financial markets.

The International Finance Corporation (IFC) Loan Officer in charge of their participation in the LIK venture also noted that the effort to revitalize international lending to developing countries was an important consideration in their decision to support the project. In other words, even if the necessary term credit were available locally, or through the internal network of IPS affiliates, it was, in IFC's opinion, more useful to encourage renewed involvement of the

international banking community in investments in Kenya.

The international commercial debt crisis and its effect on the commercial banking sector's willingness to invest in enterprises in the developing countries was becoming a major hindrance to development at the time the LIK project was being formulated, and the soundness of the proposed venture was viewed as a possible opportunity to reverse the trend. It should, perhaps, be noted that this problem continued as lending by commercial banks to the Third World fell by \$3 billion in 1985 and seems to have fallen at a more rapid rate in the first quarter of 1986.

III. The Leather Industries of Kenya Loan Agreement

This direct loan by the Bureau for Private Enterprise of USAID was the earliest and largest direct loan investment by PRE in a single company, and as of November 1984, was the only such exercise undertaken by PRE in Africa. The fact that it was undertaken is a result of numerous elements, including the designation of Kenya as one of the priority countries for the new private sector initiatives of USAID, the lack of viable alternatives on the local level for capital resources, together with the relatively high level of business sophistication of the borrower, and the export earning potential of the enterprise.

A. History, Rationale and Objectives

Leather Industries of Kenya was created as a subsidiary of Investment Promotion Services of Kenya. IPS is part of a multi-country network of companies of the same name presently established under the aegis of the Aga Khan Fund for Economic Development (AKFED), which has as its stated objective assisting economic development in the Third World through the private sector (see Appendix I). The activities of

the fund are implemented through the international network of IPS companies in 8 countries which in turn control a total of 57 associated companies worldwide. In Kenya, the AKFED umbrella includes 19 companies involved in banking, manufacturing, real estate, tourism, business services, and agro-industry. (Henceforth "IPS" will refer to IPS [Kenya] Ltd.)

The contacts between IPS and PRE were initially established during the earliest days of the Bureau's existence. Although IPS had already earned a solid reputation and did not have major problems obtaining both local and international investment capital, its principals were extremely keen on having USAID involvement in their operations. This was due in part to the fact that IPS was in the process of undertaking more activities in agribusiness development and recognized USAID's long history in agricultural development in Kenya. It was also believed that USAID support would provide an additional element of legitimacy and protection for the IPS position in Kenya. In providing direct loan assistance to LIK, PRE seized on the second agribusiness investment opportunity that was presented to it by IPS. PRE had earlier chosen not to participate in an IPS jojoba oil production project of an equally long term nature in Kenya's semi-arid northern area. This project was subsequently financed in part through loans from German and Dutch sources.

IPS was, at the time of initial contacts with PRE, well recognized as an excellent venture capital organization in Kenyan commercial and development circles. It had received financing from IFC, other bilateral lending agencies, and local commercial lending institutions for a number of its ventures. Two of the AKFED companies are public

companies traded on the Nairobi stock exchange.

The development of the Leather Industries of Kenya venture by IPS was in response to a number of economic factors related to international trade trends, underutilized local resources and national priorities in the development of the Kenya economy. During the preceding two decades there had been a decline in the export of unfinished hides from developing countries to developed countries and a reverse flow in the supply of raw materials for leather finishing to developing countries. This was due in large part to the lower costs of leather processing in the developing countries, and possibly related to less stringent environmental protection requirements in the Third World.

Kenya, however, had not been a major participant in this trend, and during the five year period (1975-80) preceding project conceptualization, was still exporting over 70 percent of its hides in unprocessed form. One reason for the lack of exploitation of this resource in Kenya was posted by the IFC Officer mentioned above, who pointed out the fact that a major source of private capital in Kenya, i.e. the Asian (Hindu) community, had cultural prohibitions against processing of cattle products.

The value added potential of processed leather for export was recognized by the government of Kenya, which attempted to stimulate an increase in local processing activities through its ban on raw hide export. (At the time, the export price for rawhides was more attractive than the domestic price paid by local processing enterprises at the time.) The proportion of semi-processed or semi-finished leather in this export sector has increased steadily during the last five years, but the finished leather proportion has remained constant at around 5 percent.

The LIK project is somewhat unique on the Kenya scene in that it is targeted specifically at increasing the export of finished leather of high quality. The processing of raw hides to finished leather for the high value end of the international leather market involves a relatively high level of technology, and demands significant efforts at quality control at all levels of the production process including the supply chain. It also has both higher profit and higher risk potential.

This important quality control factor necessitated planning for upgrading traditional practices in slaughtering and preservation of hides and the introduction of new technology in the production process.

In addition to the attractiveness of the proposal as a potentially profitable investment opportunity, the project with its backward linkages contributing to agriculture-based development in a number of USAID priority areas, was an appropriate vehicle for PRE investment. Potential effects including employment generation, technology transfer, and rural income improvement, together with the high potential for increased income from export through the Kenyan private sector provided an excellent "fit" into the PRE mandate.

As indicated earlier, the establishment of LIK operations did not rise or fall on the availability of the PRE loan. The IPS track record, and the profit potential of the enterprise may have been sufficient incentive for other investors if PRE funds had not been available. PRE had been alerted to the proposed venture through its contacts with IFC, and was able to suggest some of its areas of concern for inclusion in the feasibility study being conducted by IPS. With USAID/Kenya providing monitoring back-up, those concerns, including the environmental soundness of the tanning facility and the participation of

Kenyan investors were addressed in the study. The participation of USAID was viewed as highly desirable from the point of view of IPS. There is some sensitivity to the fact that IPS is controlled to a great extent by the Ismaili community in Kenya, and the participation of USAID could be viewed as adding further legitimacy to their operations. From the point of view of USAID, an investment in an enterprise backed by the human resources of IPS represented a relatively safe and effective use of funds, and a potentially significant contribution to increased export earnings over a long period of time.

B. Terms and Conditions of the Loan

The loan to Leather Industries of Kenya is noteworthy in a number of ways:

1. It is a large investment in a single agro-industrial enterprise;
2. The enterprise is specifically, and in concept was exclusively aimed at the export sector;
3. The enterprise attempts to substantially raise the technological level of the existing industry in which it operates.

Other elements which must be considered important in terms of analysis are that the financial organization of the enterprise involves a mix of international and local capital inputs both in debt and in equity. The investment analysis, as well as the corporate structuring was developed almost exclusively by a local business entity (IPS) using its own technical resources. IPS did profit from some technical assistance from the IFC desk officer, but the feasibility study process was handled for the most part by IPS.

The PRE loan is for a total of \$2 million at 12 percent interest accruing as of 6 months after the first disbursement under the loan.

The total term of the loan was for 12 years, and it had a commitment fee of .5 percent on undisbursed principal. The loan and interest payments are to be in U.S. dollars.

The funds disbursed were limited to the purchase of goods and services in Kenya or in the United States. LIK officials indicated that the availability of funds which could be applied to local purchases was an attractive element of the loan conditions, and distinguished it from loans that had been proposed to IPS by other bilateral development agencies.

Funds were transferred through Standard Chartered Bank PLC of New York to Standard Bank in Kenya. It is interesting to note that the Standard Bank in Kenya, through its employee pension fund, subsequently took an equity position in LIK.

There were a number of "conditions precedent" to the loan disbursements, some of which are common to USAID projects (engineering design for construction activities, proof of legal standing, etc.). Among the other conditions unique to this venture were those requiring firm technical assistance and marketing agreements between LIK and UTAMMO, its Belgian tannery counterpart; and assurances that IPS and its affiliate companies would divest up to 50 percent of their shares to private Kenyan investors within 8 to 10 years after the project completion date. USAID also required evidence to show that the necessary capitalization of the whole project (approximately \$9.4 million) had been accomplished and that at least one third of that capitalization was equity.

As will be described below, USAID requirements with respect to environmental protection had a significant impact on the implementation of the project, and while somewhat delaying the completion of the

tannery, became one of the major distinguishing features of the LIK venture.

IV. Project Organization and Operations

A. Organization

The financial structuring of the LIK project is of major interest, representing a relatively sophisticated approach to risk spreading. Both equity and loan capital are supplied by a combination of local and international investors.

LIK has been established as a separate corporate entity under the laws of Kenya, with approximately 43 percent of equity held by Kenyan institutional investors, and the remainder held by IFC and participating technical assistance agencies, most important among which are the participating Belgian tanning company, UTAMMO, and the Belgian Corporation for International Investment (SBI).

The PRE loan was applied to construction costs of the tannery plant and its effluent treatment plant. USAID/Kenya and the USAID Regional Economic Development Support Office in Nairobi were involved in monitoring this portion of the project implementation. Strict guidelines of USAID and the Kenya National Environmental Secretariat were adhered to in construction of the treatment facilities leading to the creation of a system which is considered a model for the country. It should be noted that other tanneries in operation in the same general area had not been obliged to follow these stricter guidelines at the time of installation.

Because of the variety of investments available for start-up costs, LIK was able to combine financing for construction using local materials through the PRE loan with purchase of state of the art processing

equipment from various European suppliers through the IFC loan. In addition to the imported materials, certain processing equipment was also adapted locally to an intermediate technology level more appropriate to the Kenya context.

The establishment of the factory was accomplished at a cost that was substantially below estimates, due in part to the well-developed tender process of IPS and its long standing contacts with local suppliers, both of which led to reduced prices, particularly in the construction phase. Success in reducing costs in turn enabled LIK to install back-up systems for key components of the processing system and to modify equipment and structures for increased safety and comfort for the work force. LIK has back-up systems for all the major support components including water, electrical power, and key machinery as well as excess capacity for effluent treatment.

Another essential organization characteristic is the full participation of the technical partner, UTAMMO, a Belgian tanning company. This company holds an equity position in the company along with a Belgian investment company. Such participation is expected to assure not only the required technical assistance component, but also encourages a substantive interest in the overall success of the operation, particularly in product marketing. (See Appendix II)

The nature of the relationship between LIK and UTAMMO is particularly important in the Kenyan context because it represents a lesson learned from the experiences of a large tannery operation which is presently in receivership. Bulleys Tannery, which is located not far from the LIK site, was tied to an exclusive marketing contract with a firm in the Netherlands, which took all of the tannery's output. When

the firm in Holland became the victim of a massive misappropriation of funds by one of its Principals, it was unable to pay Bulleys for the production received. Bulleys subsequently was unable to pay its Kenyan creditors and is presently operating under a receivership. Although the tannery is operating at high capacity, its cash flow situation is tenuous at best, and its production is limited to processing only to the semi-finished stage for the foreseeable future.

LIK, on the other hand, is tied to UTAMMO for technical assistance in marketing and processing, but is free to pursue any market opportunities that may arise worldwide. With UTAMMO as one of the equity participants in the enterprise, LIK has the security of a market link with Europe without the restrictions of an exclusive contract.

B. Specific Targets

At full production, LIK will be able to process 1,000 hides per day leading to an annual production of 750,000 square meters of finished leather. Production is targeted for export to the higher fashion market in Europe, however, a variety of alternative markets have been identified as fallbacks and for exploitation during the initial production phase when efforts are being made to raise the quality of the finished product to the level necessary to satisfy the eventual market in Europe. At full production and export of quality finished leather, the tannery is expected to generate approximately a billion shillings (\$60 million) in foreign exchange earnings over a period of 10 years. Employment generated by the project is expected to reach the level of approximately 400 jobs at an investment cost per job of approximately 274,000 Kenya shillings or \$ 16,800.

C. Budget

Capitalization of the enterprise was at the level of approximately \$9.4 million, \$5.9 million of which was in loans and \$3.5 million in equity. The original PRE loan was to have been \$2 million with a cost overrun facility of \$200,000. Due to the savings in construction, and the devaluation of the Kenya shilling in late 1985, the overrun facility was not used and LIK chose to reduce the total amount borrowed from PRE by \$600,000 and establish a local currency line of credit of approximately the same amount from an IPS affiliate in order to reduce the foreign currency exchange risk.

V. Implementation and Impact

A. Implementation

Although production runs had begun on a limited basis four months earlier, the LIK operation officially began its operations in October 1986 with a widely publicized dedication attended by the President of Kenya and the Aga Khan. (It should be noted that the official dedication of the tannery took place at the same time as a major conference sponsored by AKFED dealing with the creation of an "enabling environment" for the private sector in Kenya.)

As of December 1986 the tannery was operating at 30 percent capacity with a work force of approximately 160 people. LIK took a relatively novel approach to recruitment and training of personnel. The majority of the tannery work force in the processing end are the same individuals who had been involved in the actual construction of the facilities. The tannery manager explained that they felt that it would be more beneficial to take personnel from this group because of the potential for greater identification with and loyalty to the enterprise.

"We also wanted to train people who had not learned bad habits at some other tannery", said Mr. Kassam. Women form about 25 percent of LIK's work force according to the manager. Most women are hired in clerical positions although at least one woman was observed working in the production line during the visit by the evaluation team to the factory.

While the official start-up date did not conform to the original plan, LIK management felt that it was necessary to delay the official start-up in order to fully test equipment, complete technical training and establish firm initial markets. Although the end objective is to supply finished high quality leather to the international market, at present, production is satisfying a combination of finished and semi-finished leather export and domestic finished leather demands based on existing firm orders.

According to the tannery manager, Mr. Kassam, production increases are keyed both to actual orders and to quality assurance goals. In the interim, however, sample high quality finished products are being produced for use in marketing, and potential markets for lower quality finished leather are being explored. Of interest is the fact that the Bata Shoe Company (Kenya) Ltd., which is by far the major domestic shoe manufacturer in the country, and which has its own tannery producing finished leather for its operation, has placed orders with LIK for finished leather for use in its high fashion lines to be sold in Kenya. This would appear to indicate recognition of the preeminence of LIK in the quality finished leather market locally. This is the same niche that it hopes to carve for itself internationally. International orders, which have so far been for relatively small quantities, have been shipped air freight in order to establish LIKs reputation as an

efficient supplier. LIK is also exploring the potential market for finished leather for army boots in the Middle East.

According to the factory manager, approximately 350,000 sq. ft. of finished leather had already been exported during 1986 with the operation at 30 percent capacity. This would appear to indicate that the target of 750,000 sq.m. in annual production could be reached at full capacity.

While assuring turnover of stock through marketing of both finished and semi-finished production, LIK operation is engaged in continuous quality testing, using accepted international industry standards and equipment, in its efforts to establish a place in the higher quality (and more profitable) end of the market. Since this is a major objective of the operation, it has necessitated efforts in improving the quality of hides from suppliers. While not involving high technology, this crucial element of the agro-industrial chain presents a fairly complex problem. LIK has taken initial steps to improve the quality of its supplies through the payment of a bonus for undamaged hides. Where previously hides were paid for by weight without regard to condition, LIK offers a 40 percent premium for higher quality hides.

In order to improve the quality of hides available in its principle area of supply, LIK has distributed improved instruments through the Hides and Skins Department of the Ministry of Livestock to be used in the flaying process (removing the meat from the hide) at major slaughterhouses within a 50 km radius of Nairobi. The tannery manager indicated that there had been a marked improvement in the quality of fresh hides from two major slaughterhouse/suppliers in the area from which LIK buys directly. Mr. Mburau, a middleman/supplier, who makes daily deliveries of 20 to 100 fresh hides from three smaller

slaughterhouses outside Nairobi to the tannery, indicated that the LIK bonus led him to put pressure on the Hides and Skins Department inspectors in the area to more closely supervise flaying activities at these establishments.

The LIK tannery manager also indicated that efforts were being made to establish supply agreements with major ranching facilities whose hides tended to show much less damage than the traditional range stock. "We will buy every hide they can produce, if we can get a delivery system set up", the Tannery manager said. For the future, the tannery is also looking into the possibility of operating its own mobile flaying equipment in rangelands areas where slaughtering facilities are small scale and relatively primitive in technical practices.

B. Anticipated and Actual Development Impacts

The anticipated development impacts of this exercise centered on the potential for both direct and indirect income generation. Based on the level of operations at the time of this study, the initial goal of providing direct employment for 400 persons will almost certainly be attained when the tannery reaches full production.

There is no indication at this time that LIK production has stimulated the creation of additional employment indirectly through providing a market for semi-processed hides and skins from other tanneries. The quantity of orders for finished leather received in the future will determine the need for purchases of semi-processed hide from Kenyan production. On the other hand, even at only 30 percent production the tannery is already establishing linkages with hides suppliers through its program of paying premiums for higher quality hides. These linkages include not only middlemen who collect and

transport hides from small and medium sized slaughterhouses, but also local individuals. At the time of the study, the tannery was accepting raw hides from virtually any individual who arrived at its gates. The rationale for this, according to the tannery manager, was to build up a constant supply of raw materials through insuring a certain loyalty on the part of suppliers in the immediate area. Bulleys Tannery, another major consumer of raw hides, is in competition with LIK for raw materials from the immediate area.

Although LIK was operating at only partial capacity at the time of this study, the upstream effect of increasing income to suppliers of hides was happening as anticipated. The extent to which this increased income was being further disseminated further, i.e. to the breeders of livestock, could not be verified. Since more than 80 percent of livestock in Kenya is range bred, the only point of communication with herders at present is at the major slaughterhouses where the Hides and Skins Agents operate. Thus, only those breeders supplying the Nairobi (and environs) markets are affected at present.

Assuming follow up of LIK's desire to obtain raw hides from ranch bred livestock, the prospect of increased income in that sector is more easily attainable. Given the efforts of USAID and others (for example, Technoserve), in promoting ranch breeding, stimulation of ranching activity would be highly desirable.

Downstream industrial development, which was seen as a potentially significant economic effect in the investment proposal is already becoming a reality to some extent. LIK has been contracted by BATA of Kenya to supply high quality leather for a proposed high quality line of footwear to be manufactured in the country.

LIK is also exploring the potential export market for leather

uppers. Because of lower labor costs in Kenya, the possibility of producing handcut uppers from partially damaged but usable skins is an additional value added possibility for LIK operations. Finished leather pieces which have holes in them are not of very high export value to shoe manufacturers whose uppers are produced by automated cutting machines. The addition of this processing step would increase the value added to the LIK production, as well as provide substantial additional employment.

Certain elements of the anticipated technology transfer, particularly that related to the improved practices of hide suppliers, are taking place and have been described above.

Because the tannery officially began operation in October of 1986, one month before this study, it was too early to assess the degree to which the transfer of technology in management of leather industries has been accomplished. The order from BATA indicates, however, that at least in the Kenya context improvement in technology has been recognized. The degree to which marketing to Europe is accomplished will be the bellweather indication of whether or not the anticipated transfer of management technology between UTAMMO and LIK has taken place, and efforts in that area are only beginning.

The same condition surrounds an assessment of the anticipated increase in foreign exchange earnings from the project. Although there have been some export sales, there is insufficient data to make reasonable projections concerning LIK's ability to attain its goal of 1,000 million Kshs. over ten years.

VI. Institutional Impacts

A. Investment Promotion Services

As a venture capital organization, IPS has established a number of affiliated companies in various sectors of commerce in Kenya. All of these operations appear to be profitable, but not all of them could be considered as contributing to Kenyan development efforts in any direct sense. The two most recent ventures (jojoba oil production and LIK) indicate a potential trend on the part of the organization toward the Kenyan agribusiness sector. An even more recent project in shrimp production on the coast is presently stalled in negotiations over land acquisition costs.

It would be unreasonable to attribute a movement in the direction of agribusiness solely to the influence of PRE's involvement in the LIK venture, since such activity is also a priority in Kenyan development planning and IPS policy. On the other hand, IPS officials indicated an awareness that their potential sources of finance for future ventures, including IFC and USAID, were giving a priority to the agribusiness sector.

IPS officials expressed a high degree of satisfaction with the relationship that had been developed through contacts made in the course of USAID's involvement with the LIK venture, and indicated they were hopeful that the relationship would continue as other ventures, particularly in agribusiness, were identified.

B. PRE and USAID/Kenya

Lessons learned impacted on all the parties involved in this project, some of them have been alluded to above. While this was a PRE funded program, the USAID Mission was able to assist in identifying IPS

as a potential local target for investment in line with the PRE mandate. PRE, on the other hand, was immediately equipped to seize this opportunity, and to provide technical knowhow as to the modalities for processing such an investment. Because of the mutual cooperation between USAID/Kenya and PRE in the exercise, a door was opened to a major institution in the Kenyan private sector.

IPS also gained a significant amount of understanding of USAID's policies and programs. Thus the project served, at a minimum, to increase the awareness of each member of this triangle to the priorities and capabilities of the other participants in the project. Where the USAID Mission may have recognized the private sector potential of IPS and the project, they appear not to have had at the time the knowledge or flexibility to develop that potential within the context of existing procedures. PRE, on the other hand, had a clearer knowledge of what it could do procedurally in order to take advantage of the opportunity. IPS, which rightly regarded the exercise primarily as a potentially profitable business investment was exposed to some of the larger development issues of concern to both the Mission and PRE.

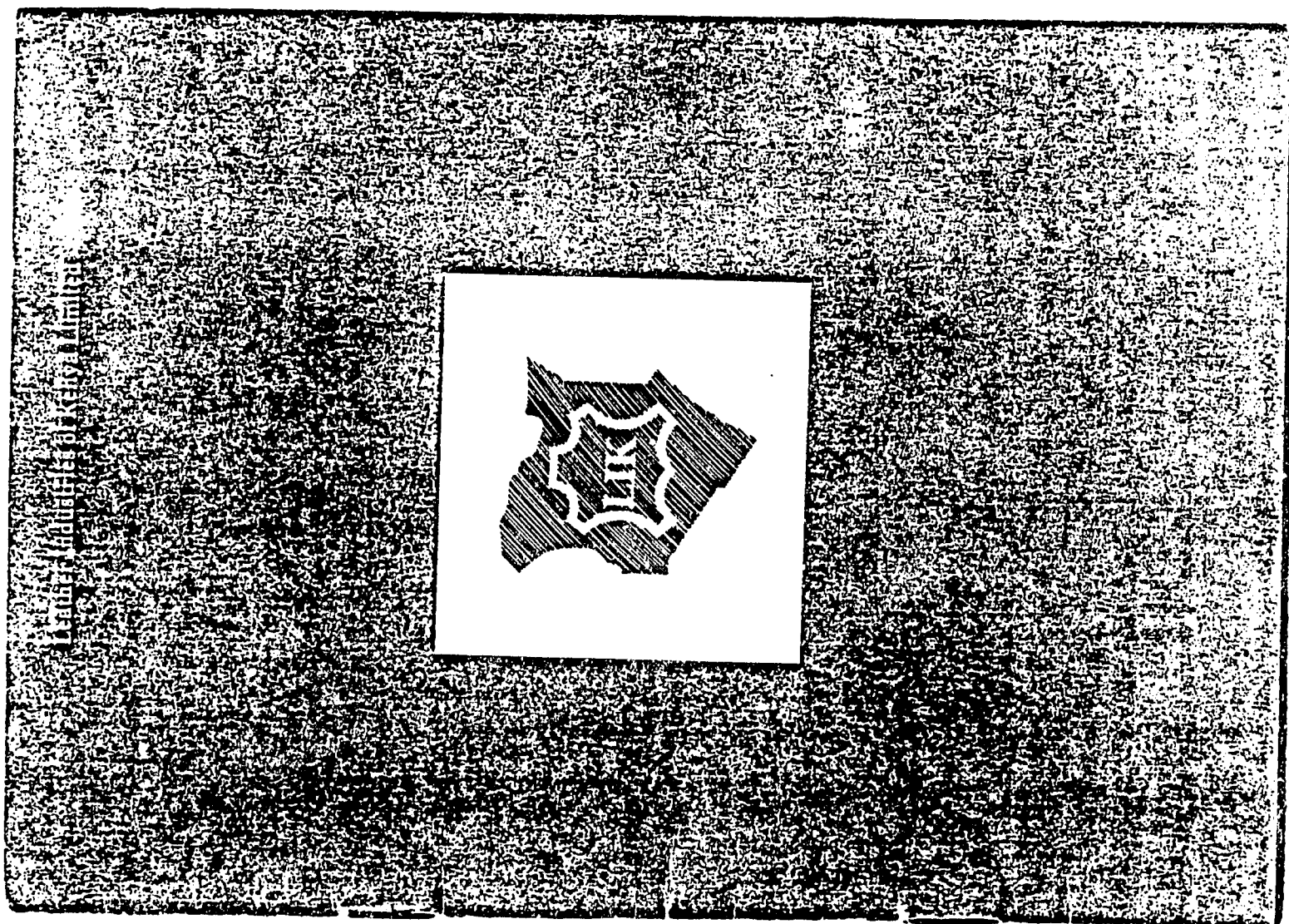
C. Other Institutions

The one element of project implementation which seems to illustrate the impact of the project on institutions involved in its implementation concerns the application of the environmental requirements of USAID. A review of the files dealing with this issue as it relates to the specific case and of other sources dealing with tannery establishments points out that while Kenya has rather strict requirements regarding industrial waste treatment, in many cases, the tannery enterprise seeks approval of local authorities to dispose of its effluent through the

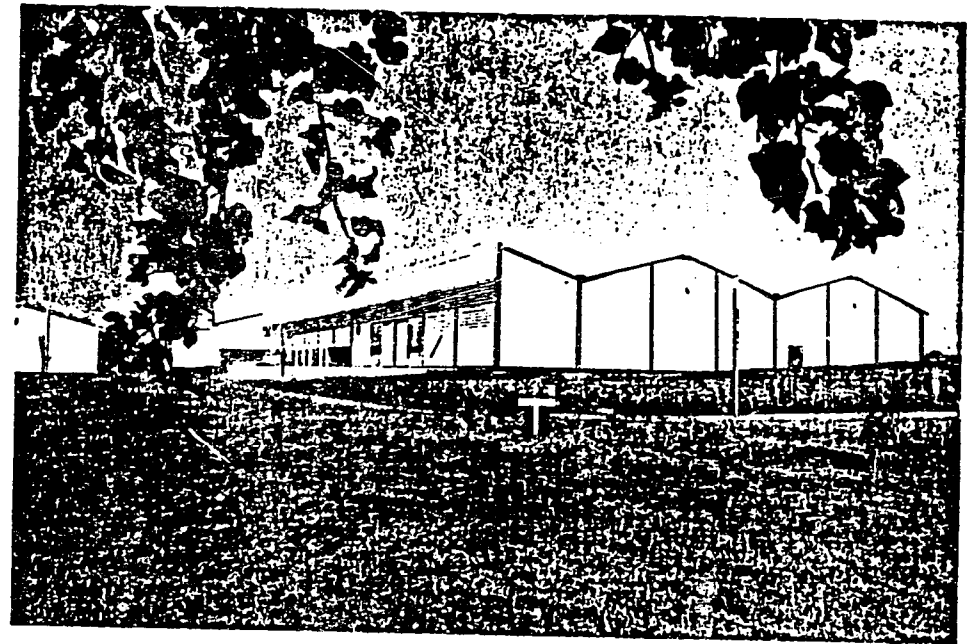
existing sewage systems.

In the feasibility stage of the project, notice was taken of the then recently established anti-pollution guidelines of Ministry of Water Development, however, notice was also taken of a proposal to install a sewage network at Athi River near the tannery. This latter option would have reduced the cost of the effluent treatment system. This option was not available at the time of the start-up, and detailed discussions were held among all the parties concerned, including IPS, the National Environmental Secretariate, and USAID technical offices. The end result is a treatment plant which is considered a model in Kenya, and in which LIK can, and does, take great pride.

The impact of this strong interaction among PRE, USAID, IPS and the Kenyan Environmental Secretariate included not only the construction of a state-of-the-art effluent treatment plant, but also a speedy institutionalization of newly established host government guidelines for a major industry. While not specifically identified as an anticipated benefit of the project, the results of this component of the implementation process can be considered a major accomplishment of the initial phase of the project.



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Tel: 22463/333275
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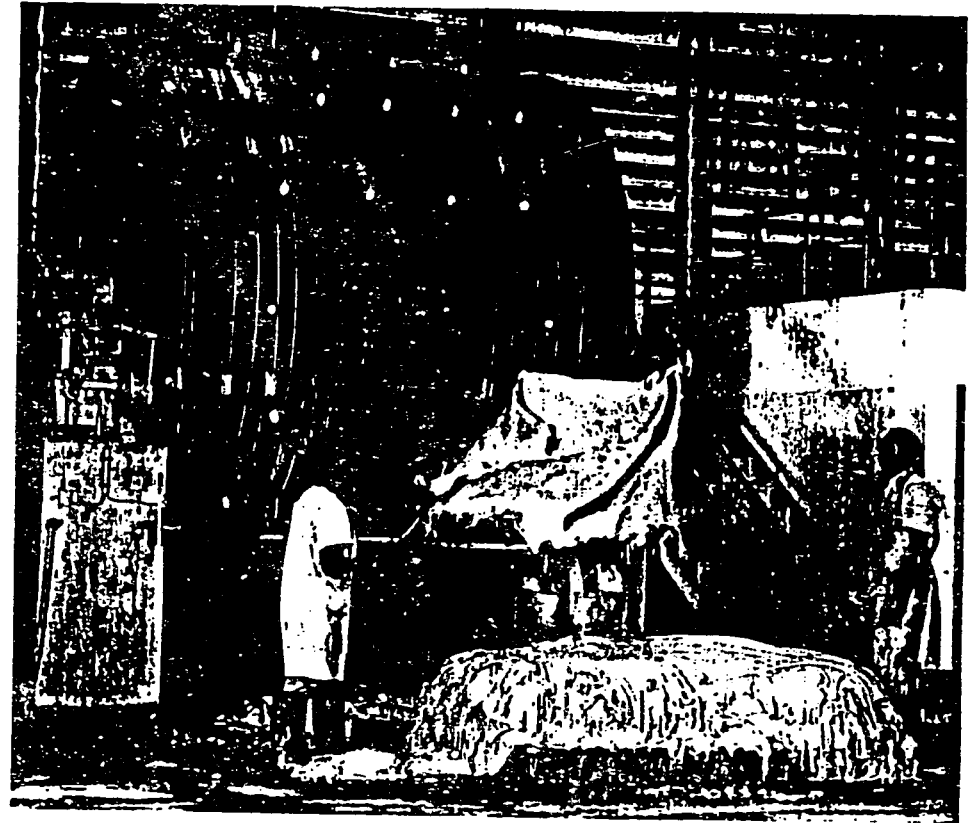
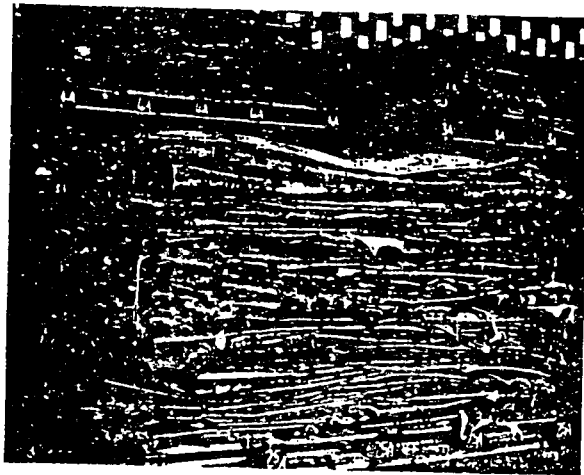
The Project

Kenya's livestock industry, representing over a quarter of its total agricultural income, constitutes one of its priority areas of development. Leather Industries of Kenya (LIK) was established to convert locally available raw hides into high quality finished leather, with significant added value, for export. LIK is a striking example of the effective combination of local resources with international technology, expertise and finance.

The LIK hide-processing plant is one of the most technologically advanced in Sub-Saharan Africa. The factory is situated at Thika, on a 30 acre site 50 kilometres from Nairobi, and is of simple but modern design. LIK has installed the most modern machinery and equipment, including an effluent treatment plant which has been designed to meet the very exacting requirements of the Environment Secretariat of the Kenya Government and of the investors. All building and civil works were carried out by local architects, consultants and contractors and some of the machinery was constructed by local companies.

The Investment Agreement was signed on Friday January 13, 1984. Construction of the buildings and installation of the machinery, including trial runs, were finished well within the time assigned by the technical collaborators - the Union des Tanneries de Malmedy et Tannerie Moderne (UTAMMO). Considerable savings were made on the original budget estimated at Shs. 120.6 million, the actual cost being Shs. 109.5 million.

Dried hides before processing.



The tanning of raw hides into leather at the "wet blue" stage.



Excess liquids are removed by squeezing.

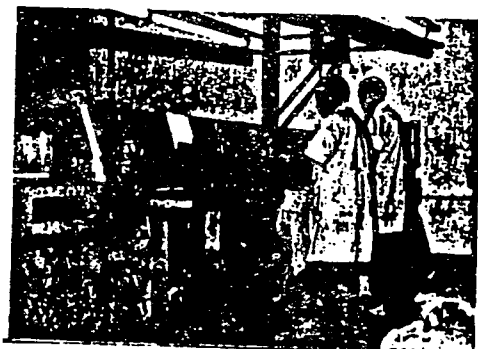
This remarkable achievement was the result of close collaboration between UTAMMO, the international development institutions involved and the local consortium leader, Industrial Promotion Services (Kenya) Limited. IPS (Kenya) is an affiliate of the Aga Khan Fund For Economic Development (AKFED) which is a development agency established by His Highness the Aga Khan.

The project also owes its speed and economy to the considerable co-operation it received from Kenya Government Departments and the Thika Municipal Council in the processing of necessary agreements and approvals. Additional assistance was given to LIK by the following: the Treasury, the Central Bank, the Ministry of Commerce and Industry, the National Environment Secretariat, the Lands Department in Nairobi and His Worship the Mayor of Thika.

The Investors

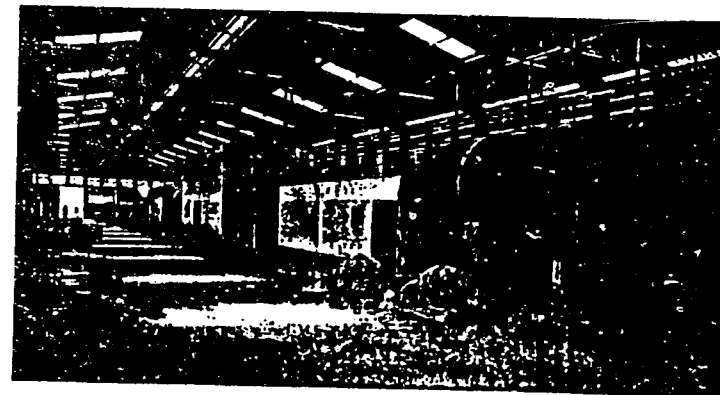
Several national and international development institutions, led by IPS (Kenya), form the consortium which has invested in LIK. They have supported the project because of its technological feasibility, its financial viability and the contribution it will make to the economic and general development of Kenya.

Equity and loan capital has been supplied by the following international institutions: the Aga Khan Fund for Economic Development; the International Finance Corporation, an affiliate of the World Bank; the United States Agency for International Development, under its PRE (Bureau for Private Enterprise) programme; The German Finance Company for Investments in Developing Countries; the Société Belge d'Investissement International; the Fund for Research and Investment for the Development of Africa, a development fund based in the Netherlands and UTAMMO, a Belgian company with over 200 years' experience in the tanning industry.

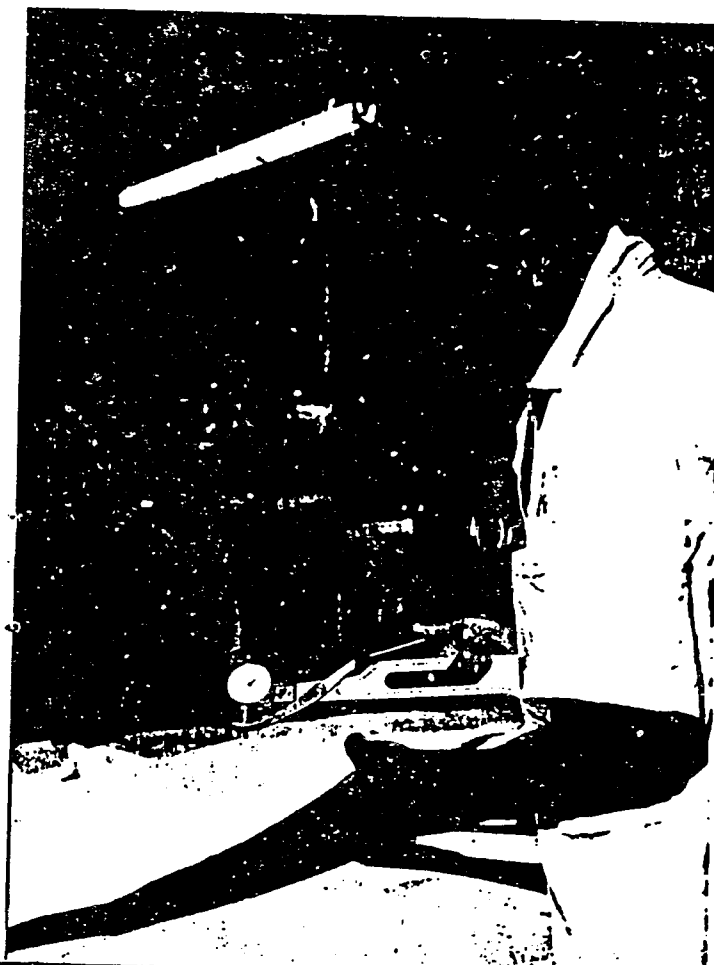


Splitting the grain surface from the suede.

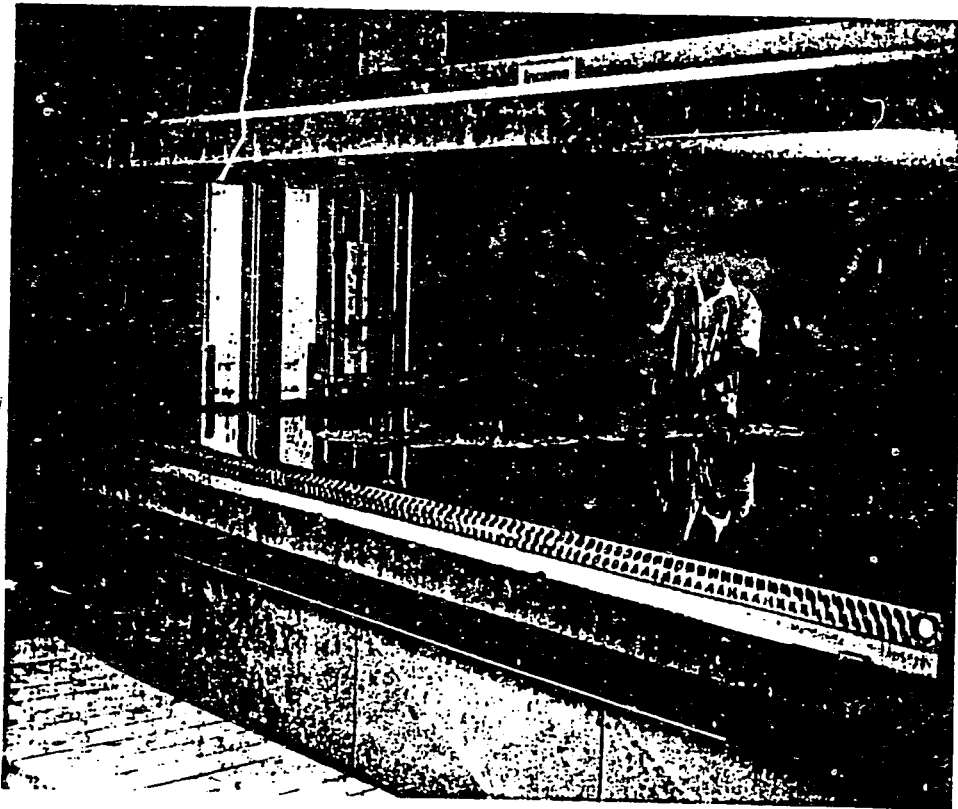
Dyeing drums.



The leather is checked for uniform thickness after shaving.



"Crust" leather.



(Top and bottom)
Controlled drying using
advanced vacuum
techniques.



Development Potential

At a national level LIK has been supported by major development and financial organisations. The Development Finance Company of Kenya Limited, the East African Development Bank, the Standard Bank plc, Standard Bank Trustee Department and the Kenyan affiliates of AKFED – namely the Diamond Trust of Kenya Limited, the Jubilee Insurance Company Limited and Industrial Promotion Services (Kenya) Limited – have each supplied equity and loan finance.

The transfer of technology from a developed to a developing country.

The role played by UTAMMO, as technical advisors to the project, involved the provision of basic civil and specialist leather engineering services. They participated both in the building works and the procurement, installation and commissioning of hide-processing machinery and utilities. Other technical assistance was given by them in the form of periodic supervision at the plant, the transfer of new technology and expertise in the areas of process techniques and documentation.

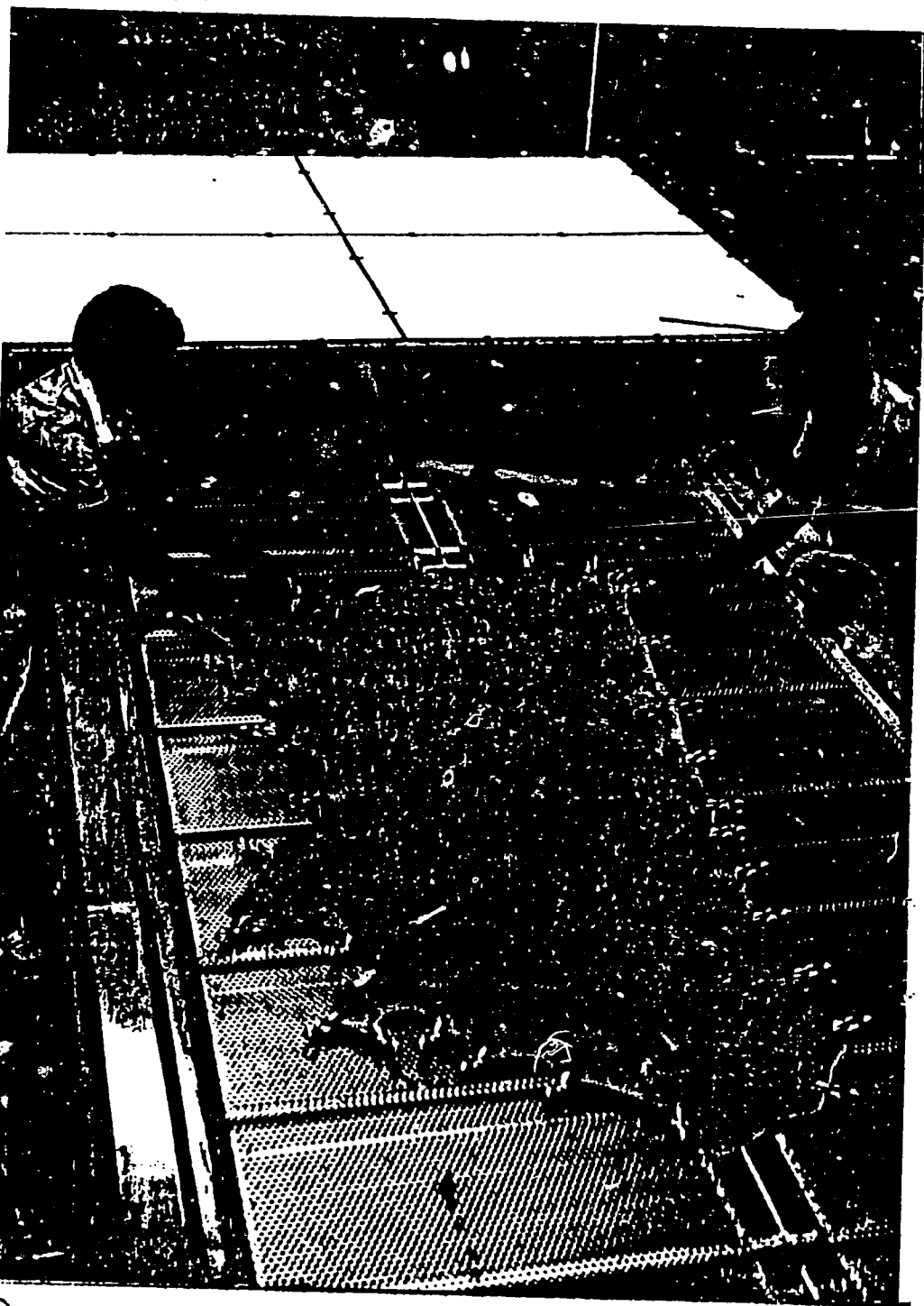
Manpower and Employment

Equal recognition has been given to the importance of a skilled workforce. LIK is expected to generate skilled, semi-skilled and unskilled employment for approximately 400 people, at an investment cost per job of approximately Shs. 274,000.

UTAMMO has assisted in the selection and training of technical personnel. Together, LIK and UTAMMO have devised a manpower development programme which will assure the future availability of well-qualified staff. UTAMMO staff, seconded to the LIK plant, will be providing on-the-job training to employees in Kenya and further training has been arranged for LIK staff at the UTAMMO tannery in Belgium and at the factories of machinery suppliers elsewhere in Europe, including Italy and France.

For the long-term, LIK has introduced a training programme which includes attendance at formal courses in Leather Technology at overseas training colleges followed by practical training. Two European governmental organisations support and finance the foreign exchange component of these training programmes: the General Administration for Cooperation to Development in Belgium and the Istituto Nazionale Per il Commercio Estero in Italy.

*Leather drying flat on a
steam-heated tanning dryer.*



Process Development

To maintain and improve the quality of finished leather it is essential to also ensure an adequate supply of hides of consistent quality. The Kenya Government has a well-defined livestock policy which has recognised this need. The Livestock Department of the Ministry of Agriculture has a well-organized Hides and Skins Improvement Service which provides training facilities aimed at the improvement of hide drying, flaying and fleshing practices and the encouragement of the use of proper implements. LIK also proposes to provide similar assistance to its hide suppliers.

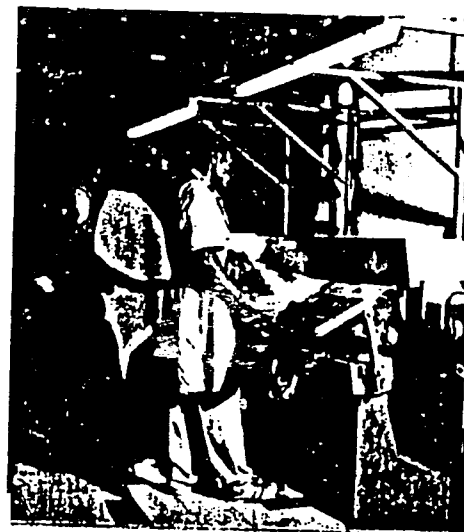
Generation of Foreign Exchange

LIK will export to the markets of Western Europe, the Middle East and the countries of the Preferential Trade Area. At full production, export sales will enable LIK to generate foreign exchange in the order of Shs. 1,000 million over a period of 10 years.

Ecological Considerations and Pollution Control

Under the auspices of the National Environment Secretariat, the Government has imposed very stringent regulations to combat the complex and demanding environmental and pollution control problems created by tanneries; problems common to tanneries all over the world. Compliance with equally stringent conditions was also imposed by the investors, particularly by USAID.

To meet these requirements, LIK has installed an effluent treatment facility, which has been judged to be a model for the tanning industry as a whole. It also provides Thika with an example, of a very high standard, for its own local pollution control activities.



*Buffing to remove
surface blemishes from
the grain.*

Raw Hides to Finished Leather

Although technologically advanced chemical and process control techniques are employed, the tanning and finishing of leather is still a specialist art and the quality of the final product is dependent upon the knowledge and craftsmanship of the experienced tanner. It can be likened to the making of fine wooden furniture. No two hides are the same just as the wood from one tree differs from another; consequently, the order and combination of the processes are not formal but varied according to the needs of the end user, the quality of the raw hides and the finish that is requested by the buyer.

The Raw Material

Kenya has a very large livestock population and is a substantial consumer and exporter of beef; and as a result, a plentiful supply of raw hide is available. LIK follows a systematic hide procurement policy. Hides either arrive at the factory in their fresh state – LIK has arrangements with abattoirs in and around Nairobi for the daily collection of fresh hides by refrigerated vans – or are delivered from large dispersed drying barns across Kenya, as dried hides. A well-connected network of purchasing agents throughout the country supplies LIK with enough raw material to meet its production requirements of 1,000 finished hides per day.

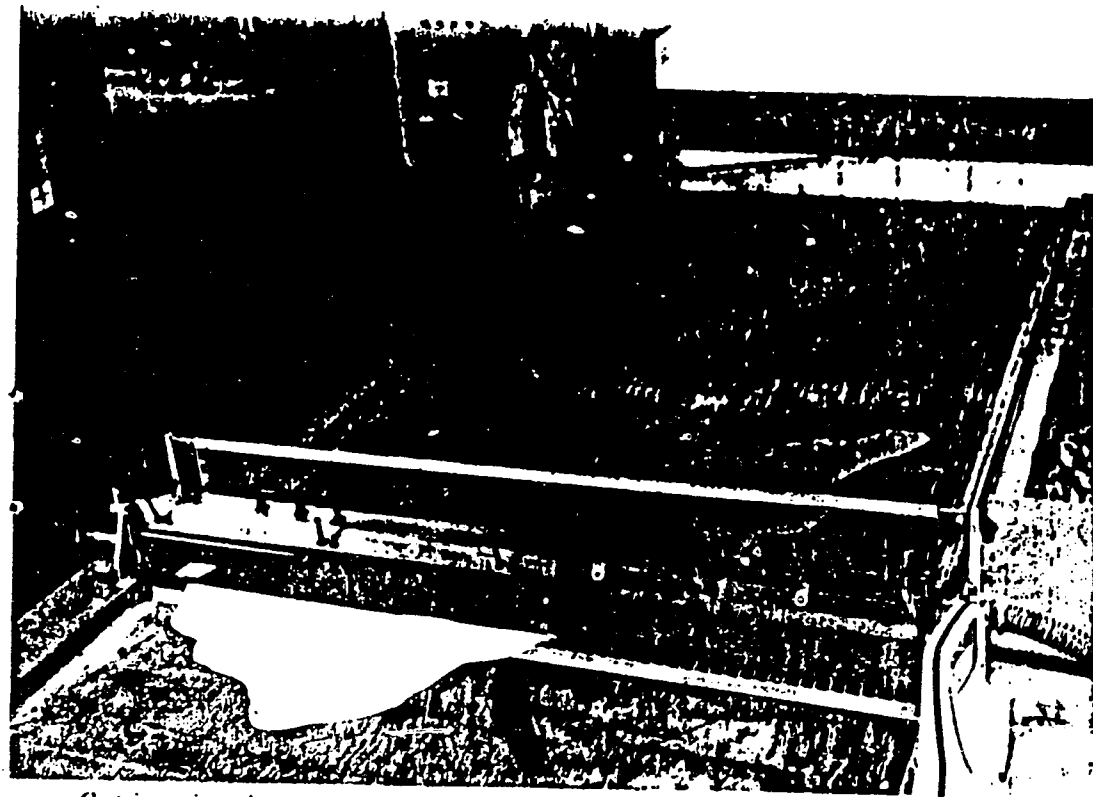
The Production Process

The processing of raw hide, fresh or dried, into fine finished leather takes approximately twenty four days and follows three main stages, "wet", "drying" and "finishing".

The "Wet" Stage

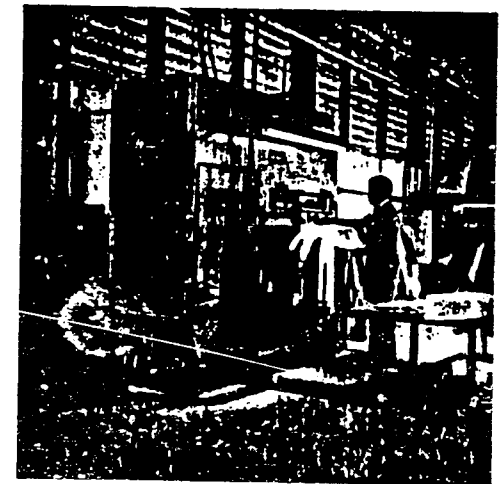
Before dried hides can be used they must be soaked in water in large pits for 24 hours to return to their true moisture content. Both raw and the soaked dried hides are then scraped to remove any unwanted flesh before weighing for quality and process control purposes. After this, the moistened hides then undergo a series of soaking, liming, fleshing and washing processes to free the skins from hair, dirt and any residual flesh which would inhibit the success of the tanning process. At this stage the hides are cut into two lengthwise and trimmed.

Tanning is the bio-chemical process which converts the raw hide into leather. As in the previous processes it takes place in large revolving drums. The hides are prepared for tanning in three stages: "de-liming" to neutralise the liming chemicals; "batting", an enzymic treatment which softens the skins making them more supple and sensitive to the tanning agents and controlled "pickling" in acid which has a partial tanning action.



Curtain coating using a pigment and resin mixture.

Spray coating.



Surface texture is given to the leather using an embossing press.

Leather grain
embossing machine.



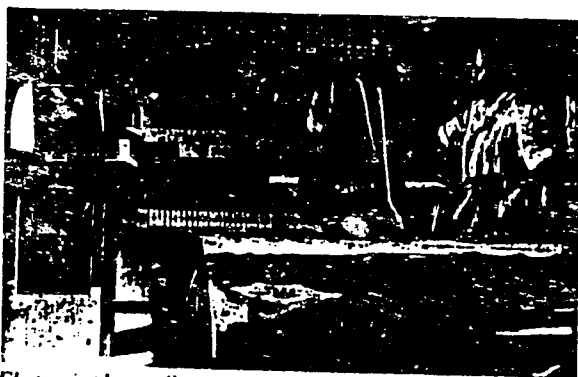
The "Drying" Stage

The hides are then treated with a carefully balanced blend of chromium salts, each blend controls the length and type of tanning required by a particular finished leather. The product at this stage is known as "wet blue" because the chromium salts are responsible for its blue colouration. The next process, "sammying", squeezes out the excess water before the leather is split laterally with a band saw to separate the very valuable grain surface from the suede. The separated grain is then passed through a highly accurate shaving machine which ensures a uniform thickness across the skin.

At this point the quality and thickness of grain sides and splits is assessed and they are sorted into batches for finishing as lots of a specific colour. During the "drying" stage the tanner aims to make any necessary improvements to the leather and to prepare it to receive the final surface finish. This is effected through particular combinations of controlled retannage, dyeing, fat liquoring – the softening of the leather with fats and oils – and drying using modern vacuum driers. The resulting leather is known as "crust". To ensure maximum surface area whilst retaining the optimum elasticity of the leather required by the customer the leather is slightly stretched in a moist atmosphere by leaving it pulled flat in a steam heated "toggling dryer". The surface area is then accurately measured by equipment furnished with the latest photo-cell technology.

The "Finishing" Stage

The object of finishing is to protect the leather from moisture and to give it the desired lustre or mat surface effect. Any number of combinations of "buffing" – the sanding of the top layer of the grain surface – "coating" techniques and "embossing" machines will help to level out uneven drum dyeings, hide grain blemishes and obtain special effects such as antique or two-tone. LIK's product range includes: Full Grain, Corrected Grain, Finished Splits, Gloving Splits and Dyed through Suede.



Electronic photo-cell measurement of surface area.

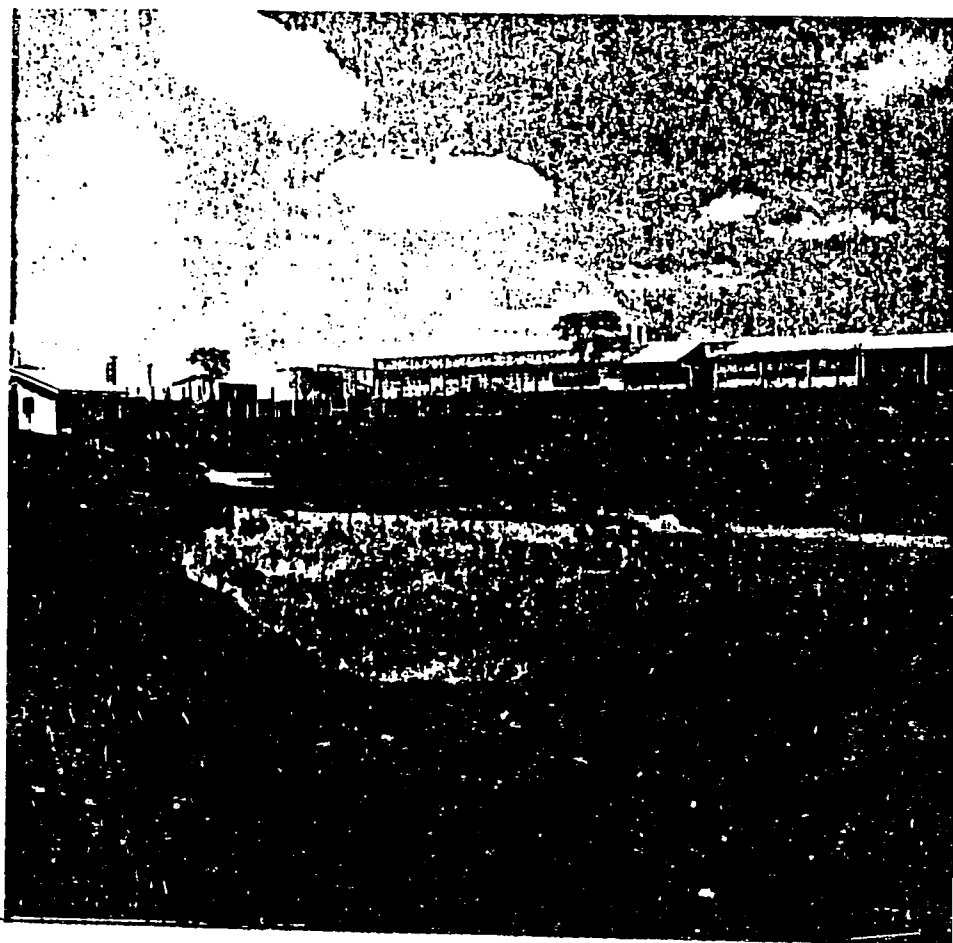
Finished leather.



The oxidation ditch of the effluent treatment plant.



The treated effluent is matured before discharge into the river.



Profiles of Investors



1. Aga Khan Fund for Economic Development

The Aga Khan Fund for Economic Development (AKFED) is a development agency established by His Highness the Aga Khan to support economic development in the Third World. AKFED seeks to promote economically viable projects which raise living standards and contribute generally to economic development. This is achieved through the use of local resources, appropriate technology and modern management techniques. AKFED associated companies supporting LIK are:



Industrial Promotion Services (Kenya) Limited;

and Industrial Promotion Services S.A.

Both companies are part of the IPS network which has operations located in Switzerland, Kenya, Tanzania, Uganda, Zaire, Ivory Coast, Bangladesh, Pakistan and Canada. IPS is a development institution founded by the Aga Khan in 1963 to encourage and expand the role of private enterprise in the developing world. Its companies act as catalysts to development in partnership with private institutions and international agencies and promote industrial, financial and tourism projects. IPS' financial support, for the most part, is in the form of equity and risk capital. Shareholders in IPS (Kenya) include the International Finance Corporation, Investors in Industry - a venture capital company jointly owned by the Bank of England and the London clearing banks - and the Kenya Commercial Finance Company Limited. This wider national and international institutional base has allowed the Company to expand its equity funding and development activities and, also, undertake pioneer projects in agro-related and other industries.



Jubilee Insurance Company Limited (JIC)

JIC, which is one of the largest and oldest composite insurance companies in Kenya is quoted in the Nairobi stock exchange. Backed by a strong, professional management team and a sound financial base, the Company operates in the mainstream of Kenya's commercial life as well as providing general insurance services to its rural and urban populations. JIC has investments in commercially viable development projects in several sectors of the economy. Recently, JIC became the first private-sector company, in ten years, to raise a new share issue on the Nairobi Stock Exchange.



Diamond Trust of Kenya (DTK)

DTK is one of the leading financial institutions of its kind in Kenya. The Company specialises in merchant banking, hire purchase and leasing and offers a full range of project financing services, with an emphasis on agricultural, tourism and export-related activities. Samuel Montagu and Company Limited, one of the leading merchant banks in London, and the International Finance Corporation are partners of this publicly quoted company.



2. Belgian Corporation for International Investment (SBI)

SBI is a semi public company established some fifteen years ago by the Belgian National Investment Corporation together with a number of large banks and commercial and industrial enterprises from the Belgian private sector. It participates in the long term financing of foreign ventures which foster economic relations between Belgium and the countries concerned. Projects supported by the SBI must show commercial profitability and be in line with the development objectives of the host country. Investment in the LIK tannery was one of the first made by SBI in Kenya.



3. Development Finance Company of Kenya (DFCK)

Leading Kenyan financial institutions and international agencies participate in DFCK, a development company incorporated in 1963. Its main objective is to contribute to the development and advancement of industry in Kenya with an emphasis on pioneer projects. DFCK's investment policy takes into account the commercial and financial viability of such projects, their potential socio-economic impact in the country as well as the availability of competent management to run the new venture.



4. East African Development Bank (EADB)

EADB was created in 1967 by the East African States of Kenya, Uganda and Tanzania. EADB's policy is to foster regional co-operation and to finance projects which would enhance the economic development of the individual member states. In conjunction with both national development institutions and foreign financiers, EADB co-finances projects in the industrial, agro-industrial, tourism, agricultural sectors as well as transport and telecommunications. Priority is given to projects that utilize locally available raw materials, create or save foreign exchange and generate employment.



5. Fund for Research and Investment for the Development of Africa (FRIDA)

Based in the Netherlands, FRIDA is a private venture capital company established to provide equity and equity-type financing for viable projects in Africa. Whilst also recognizing the economic advantages offered by the country concerned, FRIDA places emphasis on private sector projects of medium size and with good commercial prospects. FRIDA'S innovative equity type participation in LIK is its first investment in Kenya.



6. German Finance Company for Investments in Developing Countries (DEG)

DEG is the German financial institution for commercial investments in the private sector of developing countries providing risk capital and long term loans. DEG aims to assist private business in developing countries by providing joint finance and fostering cooperation between German companies and entrepreneurs in the Third World through the genuine partnership of joint venture operations.



7. International Finance Corporation (IFC)

The International Finance Corporation, an affiliate of the World Bank, was established in 1956 to promote private investment in developing countries. IFC's investment criteria focus on the potential benefit that a project has to offer the host country and upon its potential profitability. Projects financed by IFC in Africa are widely spread across the region throughout industry, agro-business, mining, development finance, energy and tourism.

Standard Chartered

8. Standard Chartered Bank Africa Plc

The Bank, which is part of the international Standard Group, was first established in Kenya in 1911. Over the past 75 years the bank has grown to be one of the leading names in commercial banking in Kenya. Drawing on its own resources and its strong international representation, the Bank is able to offer a wide range of services including foreign exchange transactions, leasing, project finance and management advisory services.



9. Union des Tanneries de Malmedy et Tannerie Moderne (UTAMMO)

UTAMMO, founded in 1776, at Malmedy in Belgium, is presently one of the largest tanneries in Europe. It boasts a tradition of the production of the highest quality finished leather, manufactured on modern equipment using the latest technology. The monthly capacity of the UTAMMO's plant is 2.5 million square feet, composed of some 50 product lines of fashion leather. More than 95% of its output is exported to countries all over the world, through an extensive sales network. Through UTAMMO's expertise and the introduction of its advanced technology, several turn-key projects and joint ventures have been successfully implemented outside Belgium.



10. United States Agency for International Development (USAID)

United States Agency for International Development (USAID), through its Bureau for Private Enterprise (PRE), provides loans to encourage the growth of the private sector in developing countries. LIK is the first investment of USAID in Africa under the PRE programme. LIK has been selected by USAID as meeting various development objectives rarely found in one project: rural employment generation, higher incomes for livestock breeders, increased foreign exchange earnings and transfer of modern technology.

Photographs by Aziz Islamshah

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